Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-1209

THE COASTAL CORPORATION, OSCAR S. WYATT, JR., H. L. BLOMQUIST, JR., GEORGE L. BRUNDRETT, JR., ERVIN O. BUCK, HAROLD BURROW, ROY L. GATES, CHARLES F. JONES, J. HOWARD MARSHALL, EDWARD J. MOSHER, WILL ODOM and FLETCHER L. YARBROUGH,

Petitioners,

—against—

JOAN WEISBERG,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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February 5, 1980

TABLE OF CONTENTS

PAGE

Table of Authorities ii

Opinion Below 2

Jurisdiction 2

Questions Presented 2

Statutory Provisions Involved 3

Statement of the Case 3

Reasons for Granting the Writ 7

1. The Decision Below Erroneously Extends the Scope of Section 14(a) of the 1934 Act to Include All Breaches of Fiduciary Duty Under State Law 7

2. The Decision Below Conflicts With a Decision of the Eighth Circuit 12

Conclusion 13

Appendix—

Opinion of the United States Court of Appeals.... 1a

Opinion of the District Court 12a

Opinion of the District Court on Motion for Reargument 13a

Table of Authorities

Cases:

	PAGE
Abbey v. *Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979)	8, 9, 12
Cort v. *Ash*, 422 U.S. 66 (1974)	7
Davis v. *Passman*, —— U.S. ——, 99 S.Ct. 2264 (1979)	11
Epic Enterprises, Inc. v. *Brothers*, 395 F.Supp. 773 (N.D. Okla. 1975)	9
Herman v. *Beretta*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,574 (S.D.N.Y. 1978)	9, 11
In re Commonwealth Oil/Tesoro Petroleum Corp. Securities Litigation, 467 F.Supp. 227 (W.D. Tex. 1979)	10
In re Tenneco Securities Litigation, 449 F. Supp. 528 (S.D. Tex. 1978)	9, 11
Kamerman v. *Pakco Companies, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,318 (S.D.N.Y. 1978), *aff'd*, 603 F.2d 213 (2d Cir. 1979)	9, 10
Lewis v. *Elam*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,013 (S.D.N.Y. 1977)	9
Levy v. *Johnson*, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,899 (S.D.N.Y. 1977)	9
Limmer v. *General Telephone & Electronics Corp.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,111 (S.D.N.Y. 1977)	9
Maldonado v. *Flynn*, 597 F.2d 789 (2d Cir. 1979)	11n
Mills v. *Electric Autolite Co.*, 396 U.S. 375 (1970)	2, 5, 6, 8

	PAGE
Nemo v. *Allen*, 466 F.Supp. 192 (S.D.N.Y. 1979)	9
Rosengarten v. *International Telephone & Telegraph Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979)	9
Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462 (1977)	7
Schley v. *Pullman Car Co.*, 120 U.S. 575 (1887)	12n
Schlick v. *Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied* 421 U.S. 976 (1975)	8
Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971)	8
Thomson v. *Gaskill*, 315 U.S. 442 (1942)	12n
TSC Industries, Inc. v. *Northway, Inc.*, 426 U.S. 438 (1976)	6

Other:

15 U.S.C. §78n	3, 4
Fed. R. Civ. P. 54(b)	6
II L. Loss, Securities Regulation (2d ed. 1961)	7n

IN THE

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No.

THE COASTAL CORPORATION, OSCAR S. WYATT, JR., H. L. BLOMQUIST, JR., GEORGE L. BRUNDRETT, JR., ERVIN O. BUCK, HAROLD BURROW, ROY L. GATES, CHARLES F. JONES, J. HOWARD MARSHALL, EDWARD J. MOSHER, WILL ODOM and FLETCHER L. YARBROUGH,

Petitioners,

—against—

JOAN WEISBERG,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners The Coastal Corporation ("Coastal"), formerly Coastal States Gas Corporation,[1] Oscar S. Wyatt, Jr., H. L. Blomquist, Jr., George L. Brundrett, Jr., Ervin O. Buck, Harold Burrow, Roy L. Gates, Charles F. Jones, J. Howard Marshall, Edward J. Mosher, Will Odom, and Fletcher Yarbrough respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on November 8, 1979.

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[1] Coastal States Gas Corporation changed its name to The Coastal Corporation, effective January 1, 1980.

Opinion Below

The opinion of the Court of Appeals, not yet officially reported, appears in the Appendix hereto. The opinion has been unofficially reported in [current] Fed. Sec. L. Rep. (CCH) ¶97,168. The opinion of the District Court and an opinion of the District Court denying a motion by plaintiff, respondent herein, for reargument were not reported and appear in the Appendix hereto.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered on November 8, 1979. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Questions Presented

1. Whether an alleged breach of fiduciary duty by corporate directors by reason of allegedly improper payments by the corporation gives rise to a federal cause of action against the corporation and the directors by a stockholder of the corporation under the Securities Exchange Act of 1934 (the "1934 Act").

2. Whether the "transaction causation" requirement for a cause of action under section 14 of the 1934 act stated by this Court in *Mills* v. *Electric Autolite Co.*, 396 U.S. 375 (1970), can be nullified by the inclusion of the setting aside of the election of directors in the relief sought by a plaintiff shareholder.

Statutory Provisions Involved

United States Code, Title 15:

§78n(a). Proxies

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title.

United States Code, Title 15:

§78aa. *Jurisdiction of offenses and writs.*

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.

Statement of the Case

Petitioners herein are a corporation (Coastal) and its directors (the "director defendants"), all of whom are defendants in this action. Plaintiff (respondent herein) is allegedly a stockholder of Coastal, a publicly held com-

pany whose shares are traded on the New York Stock Exchange. The sole claim involved in the appeal to the Court of Appeals (the first claim) purports to sound directly against Coastal States and the remaining defendants under §27 of the 1934 Act (15 U.S.C. §78n). The claim purports to be brought on behalf of a class consisting of "all persons who were stockholders of Coastal . . . of record from whom proxies were solicited for the election of directors in 1974, 1975, 1976, 1977, and 1978."

In her first claim, plaintiff alleges that the director defendants were elected to the Board of Directors of Coastal in the years 1974 through 1978. Plaintiff then alleges that in 1973 and 1974 Coastal paid in excess of $8,000,000 to defendant Selman Holdings Ltd. ("Selman") "in large part in the guise of commissions on various transactions in which Selman Holdings Ltd., rendered no such service." The complaint further alleges that the payments to Selman in fact constituted a bribe to another defendant, Leonardo Moleiro, who is alleged to have been a consultant to or an officer or employee of a Venezuelan state-owned oil company.

During 1976, the Audit Committee of Coastal's Board of Directors conducted an investigation to determine if there had been any improprieties by Coastal in payments of commissions, fees, or other items during the preceding five years. The Audit Committee reported that it found no improprieties with respect to such payments. A Form 8-K containing this report of the Audit Committee was filed by Coastal with the Securities and Exchange Commission in November 1976.

The complaint then asserts that the report of the Audit Committee and proxy statements circulated by Coastal were false and misleading in that they failed to disclose

"the complicity of the management of Coastal States Gas Corporation in the aforesaid bribe" (comp. par. 24) and that the proxy statements were further false and misleading "in failing to disclose the information that was known to the audit committee with regard to the bribe" (comp. par. 25).

In her first claim, plaintiff further alleges that by reason of the allegedly false and misleading proxy statements, certain elections of Coastal's directors were void (comp. par. 26) and that plaintiff "has sustained damage in that her right to receive a complete and truthful proxy statement has been violated" (comp. par. 28).

There was no allegation that the question of whether the allegedly improper payments should have been made was ever submitted to the shareholders of Coastal for approval or ratification.

Significantly, plaintiff's remaining claims, not involved in the appeal to the Court of Appeals, purport to sound derivatively on Coastal's behalf, and, with the exception of a second claim merely restating the first claim as a derivative claim, are explicitly premised on state law. Plaintiff alleges for example that Coastal "has been damaged . . . by the acts of the defendants" and that the director defendants "have failed to account for assets [of Coastal] which were under their custody and control." The relief sought by plaintiff includes damages, a declaration that the election of directors is void, and the appointment of a receiver until a new election can be held.

The District Court granted Coastal's motion to dismiss the first claim since it "fail[ed] to satisfy the transaction causation requirement of *Mills* v. *Electric Autolite Co.*, 396 U.S. 375, 385 (1970)" (Appendix, p. 12a). A subsequent motion for reargument by plaintiff was denied by the Dis-

trict Court (Appendix, p. 13a). Subsequently, the director defendants moved to dismiss the first claim (and the remaining claims on the grounds of lack of jurisdiction over their persons), and this motion was granted. A final judgment dismissing the first claim was entered pursuant to Fed. R. Civ. P. 54(b), and plaintiff appealed.

The Court of Appeals reversed on the grounds that plaintiff was not seeking damages because of allegedly improper payments, but rather challenged the election of directors (Appendix, p. 9a). On the basis of this theory, the Court of Appeals found the transaction causation requirement of *Mills* satisfied. The effect of the ruling of the Court of Appeals was thus to cause these individual defendants, who are residents of Texas, to have to appear in the United States District Court for the Southern District of New York, which would otherwise not have jurisdiction over their persons.

Having found the transaction causation requirement satisfied, the Court of Appeals further considered whether the complaint satisfied the materiality requirement of *Mills* as refined in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976). In view of allegations by plaintiff regarding "kickbacks" (which allegations appear nowhere in plaintiff's complaint), the Court of Appeals found that plaintiff "had a right to some discovery or other opportunity to develop a factual record before [the] materiality question was decided" (Appendix, p. 10a). The case was remanded to the District Court for further proceedings consistent with the opinion of the Court of Appeals.

REASONS FOR GRANTING THE WRIT

1.

The Decision Below Erroneously Extends the Scope of Section 14(a) of the 1934 Act to Include All Breaches of Fiduciary Duty Under State Law.

Petitioners respectfully submit that the Court of Appeals' holding that plaintiff's complaint states a cause of action under Section 14 of the 1934 Act erroneously extends the scope of the 1934 Act to encompass claims against directors for breaches of fiduciary duty for which effective remedies exist under state law and which Congress did not intend to federalize in the name of the more limited goal of regulation of proxy solicitation.[3] *See Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 479 (1977) ("Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overriden"); *Cort* v. *Ash*, 422 U.S. 66, 84 (1974) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with

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[3] As Professor Loss has noted, the inclusion of proxy regulation in the 1934 Act was the result of "state law being a virtual void with respect to disclosure in the solicitation of proxies" (II L. Loss, Securities Regulation 866 (2d ed. 1961)), not with an intent to create a new federal law as to the fiduciary duties of directors. Thus the 1934 Act was enacted against a background of such practices as consideration of matters at meetings of shareholders which were not included in the notice of meeting and solicitation of proxies by management authorizing the proxy holder "to take any . . . action which was considered desirable" (*id.* at 858).

respect to stockholders, state law will govern the internal affairs of the corporation"); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971).

In *Mills* v. *Electric Autolite Co.*, 396 U.S. 375 (1970), this Court dealt with the question of "what causal relationship must be shown" between a materially false and misleading proxy statement and the transaction complained of in order to establish a cause of action under section 14 of the 1934 Act (396 U.S. at 377). The answer by the Court was as follows:

> . . . Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. 396 U.S. at 385.

Thus in addition to the requirement of materiality, a separate requirement, sometimes termed "transaction causation" (*see, e.g., Abbey* v. *Control Data Corp.*, 603 F.2d 724, 731-732 (8th Cir. 1979); *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 381-382 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975)), must be satisfied before a cause of action under the 1934 Act is stated.

In *Mills* where the transaction was a merger, requiring the approval of a substantial number of minority shareholders (396 U.S. at 379), this Court found the transaction causation test satisfied where a shareholder vote approved the merger based upon a materially false and misleading proxy statement. By contrast, where the transaction authorized by the allegedly false or misleading proxy material is the election of directors, previous improper corporate payments (as breaches of fiduciary duty) are not approved by shareholders voting for directors, and thus are not caused by the proxy statement. Hence, prior to the instant case, the transaction causation element was uniformly held to have been lacking in such cases. *See, e.g., Abbey* v. *Control Data Corp.*, 603 F.2d 724, 731-732 (8th Cir. 1979); *Rosengarten* v. *International Telephone & Telegraph Corp.*, 466 F. Supp. 817 (S.D.N.Y. 1979); *Nemo* v. *Allen*, 466 F. Supp. 192 (S.D.N.Y. 1979); *Kamerman* v. *Pakco Companies, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,318 (S.D.N.Y. 1978), *aff'd*, 603 F.2d 213 (2d Cir. 1979); *Herman* v. *Beretta*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,574 (S.D.N.Y. 1978); *In Re Tenneco Securities Litigation*, 449 F. Supp. 528 (S.D. Tex. 1978); *Limmer* v. *General Telephone & Electronics Corp.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,111 (S.D.N.Y. 1977); *Lewis* v. *Elam*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,013 (S.D.N.Y. 1977); *Levy* v. *Johnson*, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,899 (S.D.N.Y. 1977); *Epic Enterprises, Inc.* v. *Brothers*, 395 F. Supp. 773 (N.D. Okla. 1975).

As one court has stated:

> . . . the courts have been understandably loath to use Section 14 as a tool to redress depredations of company assets which may be logically related to a given director's fraudulent election to office, but which are not themselves the subject for which shareholder approval was sought. Prosecutions under Section 14(a) may properly seek to remedy only corporate actions fraudulently induced by misleading proxy statements and to obtain damages flowing directly

> from such misconduct, see e.g. *Lowenschuss* v. *Kane,* 520 F.2d 255 (2d Cir. 1975) (decline in stock value attributable to false proxy statement recoverable under Section 14(e); *Gould* v. *American Hawaiian SS. Co.,* 535 F.2d 761 (3d Cir. 1976). This statute, however, cannot be stretched to provide for recovery for other misdeeds committed by such corporate official not immediately related to the action engendered by the proxy statement. To hold otherwise would render Section 14 a key with which to open the doors of the federal courts to all manner of state and common law claims.

Kamerman v. *Pakco Companies, Inc.* [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,318 (S.D.N.Y. 1978), *aff'd,* 603 F.2d 213 (2d Cir. 1979). *See In re Commonwealth Oil/Tesoro Petroleum Corp. Securities Litigation,* 467 F. Supp. 227, 238 (W.D. Tex. 1979).

In the instant case, the Court of Appeals did not question that these cases were rightly decided. Rather it purported to distinguish them on the grounds that:

> . . . In the cases relied on by appellees, the plaintiff sought damages because of allegedly improper payments, which did not require shareholder approval. . . . In the instant case, however, the challenged "transaction" is the election of the directors, and we have no doubt that the "proxy solicitation itself . . . was an essential link in the accomplishment" of that transaction, within the meaning of *Mills.*

(Appendix, pp. 8a-9a, footnote omitted). The distinction by the Court of Appeals between a plaintiff seeking damages, and a plaintiff seeking to overturn the election of

directors[3] cannot determine whether a cause of action exists under section 14 of the 1934 Act. As this Court stated in its last term: ". . . the question whether a litigant has a 'cause of action' is analytically distinct and prior to the question of what relief, if any, a litigant may be entitled to receive." *Davis* v. *Passman,* —— U.S. —— (1979), 99 S. Ct. 2264, 2274 (1979).

As courts other than the Court of Appeals have noted, if a plaintiff can evade the requirement of transaction causation simply by arguing that he attacks the election of directors rather than the allegedly improper payments, the requirement is rendered a nullity, since any alleged breach of fiduciary duty is thereby converted into a federal cause of action under section 14 of the 1934 Act. *Herman* v. *Beretta* [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,574 (S.D.N.Y. 1978). *In re Tenneco Securities Litigation,* 449 F. Supp. 528, 532 (S.D. Tex. 1978).[4]

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[3] In fact plaintiff herein apparently seeks both damages and to overturn the election. The Court of Appeals stated "The *principal* relief plaintiff seeks is an order setting aside the election of Coastal's directors and appointing a receiver pending a new election" (Appendix, p. 3a, emphasis supplied).

[4] The Court of Appeals stated that an "obvious danger" of its reversal herein was "the expansion of the section 14(a) action to encompass myriad allegations of corporate waste that have traditionally been the concern of state courts" (Appendix, p. 11a). The Court of Appeals gave no guidance as to how this "obvious danger" is to be avoided beyond stating that "in our recent opinion in *Maldonado* v. *Flynn,* 597 F.2d 789 (2d Cir. 1979) . . . we rejected any attempt to use section 14(a) in such a manner" (Appendix, p. 11a). It is respectfully submitted that the Second Circuit's decision in the instant case permits precisely the type of section 14 claim the Court purportedly rejected in *Maldonado*—a state law claim for waste of corporate assets. In permitting the section 14 claim in *Maldonado* to be asserted, the Court of Appeals overruled a portion of "a scholarly and thoughtful opinion" (597 F.2d at 791) by Judge Weinfeld (448 F.Supp. 1032 (S.D.N.Y. 1978)).

It is respectfully submitted that the extension by the Court of Appeals of section 14 of the 1934 Act to provide a cause of action for alleged breaches of fiduciary duty for which a proxy solicitation was not "an essential link in the accomplishment of the transaction" was erroneous.[5]

2.

The Decision Below Conflicts With a Decision of the Eighth Circuit.

In *Abbey* v. *Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), the Eighth Circuit held that a stockholder does not have a cause of action under section 14(a) for alleged "illegal payments made by the corporation to certain foreign entities" (603 F.2d at 726). Plaintiff in *Abbey*, like plaintiff herein, sought equitable relief (the cancellation of stock options approved by shareholders during the period when the allegedly illegal payments were made). In holding that plaintiff's claim was properly dismissed, the Eighth Circuit stated:

> Several courts have refused to find a federal remedy under §14(a) for secret, illegal corporate payments. They have required "transactional causation" as an essential element of a §14(a) cause of action: the harm to plaintiff-shareholders must have resulted from the corporate transactions which were authorized as a

[5] It is respectfully submitted that plaintiff's allegations of "kickbacks", which appear nowhere in the complaint (*Thomson* v. *Gaskill*, 315 U.S. 442, 446 (1942), *Schley* v. *Pullman Car Co.*, 120 U.S. 575, 578 (1887)), are irrelevant to the merits of this petition. The Court of Appeals considered the allegations of kickbacks only with regard to whether plaintiff had satisfied the separate "materiality" requirement of a cause of action under section 14(a), and after it had erroneously concluded that the "transaction causation" requirement had been met (Appendix, pp. 9a-10a).

> result of the false or misleading proxy solicitations. *See In re Tenneco Securities Litigation.* . . . 449 F. Supp. at 531; *Lewis* v. *Elam*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) at ¶ 96,013. Any injury to CDC shareholders from the corporation's illegal foreign payments stems directly from the corporate waste and mismanagement involved in authorizing those payments and not from allegedly misleading proxy solicitations dealing with unrelated corporate business matters. Consequently, we determine that [plaintiff's] §14(a) claim is also at best marginally related to the federal policies underlying that section.

603 F.2d at 732. It is these settled principles regarding the scope of section 14(a) which we submit the Second Circuit erroneously failed to apply in the instant case.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Second Circuit.

Respectfully submitted,

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February 5, 1980

APPENDIX

Opinion of United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 215—September Term, 1979.

(Argued October 16, 1979 Decided November 8, 1979.)

Docket No. 79-7417

JOAN WEISBERG,

Plaintiff-Appellant,

—against—

COASTAL STATES GAS CORPORATION, OSCAR S. WYATT, JR., H. L. BLOMQUIST, JR., GEORGE L. BRUNDRETT, JR., ERVIN O. BUCK, HAROLD BURROW, ROY L. GATES, CHARLES F. JONES, J. HOWARD MARSHALL, EDWARD J. MOSHER, WILL ODOM, FLETCHER L. YARBAROUGH, JULIO IGLESIAS, and SELMAN HOLDINGS, LTD.,

Defendants-Appellees,

—and—

ESTATE OF HARRY G. FAIR, WARREN L. SMITH, LEONARDO MOLEIRO, and ROBERT IGLESIAS,

Defendants.

Before:

KAUFMAN, *Chief Judge,*
SMITH and FEINBERG, *Circuit Judges.*

Appeal from judgment of the United States District Court for the Southern District of New York, Lloyd F. MacMahon, *J.*, dismissing the first claim of plaintiff's complaint, alleging violation of proxy rules.

Reversed and remanded.

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ROBERT E. WALLS, Houston, TX, *for Defendant-Appellee Coastal States Gas Corporation.*

DEBEVOISE, PLIMPTON, LYONS & GATES, New York, NY (Asa Rountree, Roger E. Podesta, of Counsel), *for Defendants-Appellees Ervin O. Buck, Charles F. Jones, J. Howard Marshall II, Edward J. Mosher, Will E. Odom, and Fletcher L. Yarbrough.*

FEINBERG, *Circuit Judge:*

Joan Weisberg appeals from a judgment of the United States District Court for the Southern District of New York, Lloyd F. MacMahon, J., dismissing the first claim for relief in her complaint against Coastal States Gas Corporation and its directors and Selman Holdings, Ltd., and its principals, all described more fully below. The basis

of plaintiff's claim is that proxy statements used to solicit proxies for the election of defendant directors violated section 14(a) of the Securities Exchange Act of 1934 by failing to disclose that Coastal had paid over $8 million in alleged bribes to Selman Holdings and that the directors thereafter allegedly concealed this wrongful activity. The principal relief plaintiff seeks is an order setting aside the election of Coastal's directors and appointing a receiver pending a new election. For reasons indicated below, we hold that the district court erred in dismissing as a matter of law this portion of plaintiff's complaint.

I

Since plaintiff appeals from a dismissal, we must assume that plaintiff's allegations are true in order to test whether, as the district court found, the complaint was legally insufficient. Briefly summarized, the complaint alleges substantially the following. Defendant Coastal, which is primarily engaged in the production of petroleum products, is a publicly traded company whose stock is listed on the New York Stock Exchange. Defendant Selman Holdings is a Bermuda corporation owned jointly by defendants Leonardo Moleiro and Julio Iglesias. At relevant times: Defendant Moliero was both a director of International Marketing for Corporacion Venezolana del Petroleo (CVP), the government-owned oil company of Venezuela, and an officer of Ven-Fuel Inc., a corporation jointly owned by CVP and International Systems Control Corp. (ISC), an American corporation. Defendant Julio Iglesias, the co-owner of Selman, was a director of Ven-Fuel and of Fuelco Ltd., another corporation jointly owned by CVP and ISC. Defendant Robert Iglesias, son of Julio Iglesias, was an employee of Coastal and an officer

of Selman. The remaining named defendants were directors of Coastal elected during the years 1974 to 1978.

The complaint further alleges that between 1973 and 1974, Coastal paid over $8 million to Selman Holdings, ostensibly as brokerage commissions. These payments were the subject of hearings in October 1978 before the Subcommittee on Oversight and Investigation of the Committee on Interstate and Foreign Commerce of the House of Representatives. The record of the hearings, upon which appellant relies, indicates that Coastal made the payments in connection with purchases of oil from Ven-Fuel or Fuelco, that Moleiro and Julio Iglesias were the representatives of CVP and ISC respectively at Ven-Fuel and Fuelco, that there was no apparent justification for additional, separate payments to be made to Selman Holdings, and that the payments were far above normal commission payments on the purchase of oil. The complaint alleges that the payments were in fact bribes that were made with the knowledge of Coastal's directors. The complaint further alleges that in 1976 Coastal reported to the Securities and Exchange Commission (SEC) that Coastal had voluntarily investigated the "sensitive" payments to Selman through an Audit Committee, which had concluded, in essence, that the payments were not suspicious or unusual and that no further investigation was required. According to plaintiff, the Audit Committee report constituted a cover-up.

Following the October 1978 Congressional hearings, plaintiff filed her class action complaint in December 1978. Her first claim asserted that the proxy solicitation materials for the election of Coastal's board of directors in the years 1974-1978, inclusive, were misleading under section 14(a) of the Securities Exchange Act of 1934 because

stockholders were not told of management's complicity in the payment of the so-called bribes and the subsequent cover up by the Audit Committee. Plaintiff sought equitable relief only: setting aside of the elections, appointment of a receiver, and new elections.

In February 1979, defendant Coastal moved to dismiss plaintiff's first claim for relief. By memorandum endorsement, dated March 21, 1979, the district judge granted the motion because the claim did not "satisfy the transaction causation requirement" set forth in Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970) and other cited cases.[1] After plaintiff moved for reargument, the judge by memorandum endorsement dated May 2, 1979, adhered to his earlier decision, this time on the ground that

> Plaintiff makes no allegation that the bribes alleged in her first claim resulted in any kickbacks to the directors of Coastal . . . and thus, the decision in United States v. Fields [592 F.2d 638 (2d Cir. 1978)] is distinguishable.

The court entered final judgment under Rule 54(b), Fed. R. Civ. P., and this appeal followed.

II

In 1964, the Supreme Court held that there is an implied private right of action for violation of section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a). J. I. Case Co. v. Borak, 377 U.S. 426 (1964). That section

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[1] The judge also dismissed plaintiff's fifth claim for relief on the ground that it sought punitive damages, which are precluded under section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a). Plaintiff apparently does not appeal this determination.

declares it "unlawful" to solicit proxies in contravention of the rules of the SEC, and rule 14a-9 prohibits solicitations "containing any statement which . . . is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading."

Subsequently, in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), the Court further defined the elements of a section 14(a) violation. Plaintiffs, who were shareholders of Auto-Lite, alleged that the corporation's directors had violated the statute by soliciting proxies for approval of a merger with Mergenthaler Linotype Co. without disclosing in the proxy materials that they were all nominees of, and controlled by, Mergenthaler. The Seventh Circuit Court of Appeals agreed that the proxy solicitation was misleading but nonetheless concluded that plaintiffs would not be entitled to relief under section 14(a) if defendants could show on remand "that the merger would have received a sufficient vote even if the proxy statement had not been misleading." 403 F.2d 429, 436.

The Supreme Court reversed on this issue of causation, stressing that section 14(a) embodied the legislative intention "to promote 'the full exercise of the voting rights of stockholders' by ensuring that proxies would be solicited 'with explanation to the stockholders of the real nature of the questions for which authority to cast his vote is sought.'" 396 U.S. at 381, citing H.R. Rep. No. 1383, 73rd Cong. 2d Sess. 14. The decision of the Court of Appeals, in contrast, allowed a bypassing of the stockholders

> on the basis of a finding that the merger was fair . . . at least where the only legal challenge to the merger is a suit for retrospective relief after the meeting has been held. A judicial appraisal of the merger's merits

> could be substituted for the actual and informed vote of the stockholders.

396 U.S. at 381. Concluding that it could not accept "[s]uch a frustration of the congressional policy," the Court set forth the following test of causation:

> Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).

These is no need to supplement this requirement, as did the Court of Appeals, with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected,

> and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions.

Id. at 384-85 (footnotes omitted).

The *Mills* Court thus stressed that a shareholder is entitled to redress under section 14(a) if shareholder approval was necessary for the challenged transaction and if the proxy solicitation was materially false or misleading. The Court subsequently clarified the second prong of the *Mills* test in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976), by defining an omission as material if there was "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."

III

Appellant argues that the district court erred in holding in its first memorandum opinion that her complaint failed "to satisfy the transaction causation requirement of *Mills* . . . ." [2] Appellees, in contrast, have urged that we affirm the dismissal on this ground, asserting that "where the transaction authorized by the allegedly false or misleading proxy materials is the election of directors, previous improper corporate payments (as breaches of fiduciary duty) are not approved by shareholders voting for directors, and thus are not caused by the proxy statements." This argument, however, misconstrues plaintiff's claim. In the

[2] The term "transaction causation" was apparently first used in this court by Judge Oakes in Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975).

cases relied on by appellees,[3] the plaintiff sought damages because of allegedly improper payments, which did not require shareholder approval. The causal link between the proxy solicitation for the election of directors and the injury complained of—the improper payments—was attenuated at best. In the instant case, however, the challenged "transaction" is the election of the directors, and we have no doubt that the "proxy solicitation itself . . . was an essential link in the accomplishment" of that transaction, within the meaning of *Mills*. See also Berkman v. Rust Craft Greeting Cards, Inc., 454 F. Supp. 787, 793 (S.D.N.Y. 1978).

Indeed, the district judge's opinion after reargument, apparently recognized the force of plaintiff's assertion that her complaint met the "transaction causation" requirement. In his second memorandum, the judge affirmed his dismissal of the first claim, but this time on the ground that plaintiff failed to assert that the alleged bribes resulted in kickbacks to the directors, citing our recent opinion in United States v. Fields, 592 F.2d 638 (2d Cir. 1978). This new rationale, by implying that an allegation of kickbacks would have changed the result, raises the much more difficult question of whether the alleged omissions were "material." As previously noted, the Supreme Court in *Mills* emphasized that a defect in the proxy statement would not violate section 14(a) if it was "trivial" or lacked

[3] E.g., Herman v. Beretta [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,574 (S.D.N.Y. 1978) (plaintiffs sought damages and voiding of elections; latter request held moot since term of directors had already expired); Limmer v. General Telephone and Electronics Corp., [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,111 (S.D.N.Y. 1977); Levy v. Johnson, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,899 (S.D.N.Y. 1977).

"a significant *propensity* to affect the voting process." 396 U.S. at 384. This requirement of materiality, as refined in *TSC Industries* v. *Northway,* supra, required the district court in the instant case to consider whether a reasonable shareholder would find information concerning the alleged bribes and cover-up to be important in deciding how to vote on the election of directors.

Utilizing this test of materiality, we believe that it was error to dismiss plaintiff's first claim for relief on a motion to dismiss without first providing plaintiff with some opportunity to demonstrate that the alleged omissions were material. It may be, as the district court apparently held, that a director's approval of questionable payments is not material to the decision whether to re-elect him unless he received a kickback. Nevertheless, even if a distinction between "mere" bribes and bribes coupled with kickbacks makes sense (a question we need not reach), appellant had a right to some discovery or other opportunity to develop a factual record before such a materiality question was decided. See TSC Industries v. Northway, supra, 26 U.S. at 450. Plaintiff alleges that had she been provided with such an opportunity, she would have been able to establish the materiality of the alleged bribes by proving kickbacks. We cannot say as a matter of law that such an attempt would have been futile, particularly in light of the massive and unexplained overpayments by Coastal to Selman revealed in the hearings of the House Subcommittee on Oversight and Investigation. Furthermore, plaintiff's allegation of a cover-up of the alleged bribes enhances the prospect that she will succeed in demonstrating materiality, since we believe that shareholders, in deciding which directors to elect, would consider such conduct, if it occurred, more important than the initial authorization

of the payments.[4] Finally, plaintiff claims that if permitted to amend her complaint, she could make a formal allegation of kickbacks to the directors. Plaintiff should be given an opportunity to do so, since the case must be remanded in any event.

Appellees argue that a reversal here presages the expansion of the section 14(a) action to encompass myriad allegations of corporate waste that have traditionally been the concern of state courts. We recognized this obvious danger in our recent opinion in Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979), where we rejected any attempt to use section 14(a) in such a manner. However, as we noted in *Maldonado,* shareholders are entitled under the statute to truthful presentation of factual information concerning the honesty of directors in their dealings with the corporation. Id. at 796. Because plaintiff's allegations of a cover-up of massive bribes and of kickbacks to the directors, if true, would be material to the shareholders in deciding whether to re-elect directors, we conclude that plaintiff's complaint was prematurely dismissed.[5]

Accordingly, we reverse the judgment of the district court and remand for further proceedings consistent with this opinion.

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[4] Plaintiff asserts that the allegation of a cover-up is particularly significant since many corporations have voluntarily disclosed questionable payments, so that in elections of directors thereafter shareholders were not deprived of such information.

[5] Since we conclude only that the trial court should not have dismissed plaintiff's complaint without further development of a record, we need not consider whether any of the claims against individual directors are now moot. See Maldonado v. Flynn, supra, 597 F.2d at 797 n.10.

Weisberg v. *Coastal States Gas Corp., et al.*

ENDORSEMENT
78 Civ. 5942 (LFM)

The first and fifth claims of the complaint fail to satisfy the transaction causation requirement of *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970); *Limmer* v. *General Telephone & Electronics Corp.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,111 (S.D.N.Y. 1977). See *Lewis* v. *Anderson*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,739 (S.D.N.Y. 1978); *United States* v. *Fields*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,074 at 91,855-56 (S.D.N.Y. 1977), *rev'd in part on other grounds*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,552 (2d Cir. 1978); *Epic Enterprises, Inc.* v. *Brothers*, 395 F. Supp. 773, 775-776 (N.D. Okla. 1975). Moreover, the fifth claim seeks punitive damages which are precluded under Section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a). *Byrnes* v. *Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977).

Accordingly, the within motion to dismiss the first and fifth claims of the complaint for insufficiency is granted.

So ordered.

Dated: New York, N.Y.
March 21, 1979

/s/ LLOYD F. MACMAHON
Lloyd F. MacMahon
United States District Judge

Weisberg v. *Coastal States Gas Corp., et al.*

ENDORSEMENT
78 Civ. 5942 (LFM)

Upon reargument, the court adheres to its original decision. Plaintiff makes no allegation that the bribes alleged in her first claim resulted in any kickbacks to the directors of Coastal States Gas Corp., and, thus, the decision in *United States* v. *Fields*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,552 (2d Cir. 1978) is distinguishable.

Plaintiff's motion for certification pursuant to 28 U.S.C. § 1292(b) is denied in all respects. The cases cited in our endorsement of March 21, 1979 make it clear that the allegations of plaintiff's first and fifth claims do not state claims upon which relief can be granted.

Plaintiff's motion for entry of a final judgment pursuant to Rule 54(b), Fed.R.Civ.P., is granted in all respects because defendants have not shown that there is any just reason for delay. The clerk of the court is hereby ordered to enter a final judgment dismissing plaintiff's first and fifth claims.

So ordered.

Dated: New York, N.Y.
May 2, 1979

/s/ LLOYD F. MACMAHON
Lloyd F. MacMahon
United States District Judge